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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Seeking Stock-Specific and Thematic Catalysts in Large-Cap Value Investing

JERROLD K. SENSER, CFA, serves as Chief Executive Officer and Chief Investment Officer of Institutional Capital LLC. As CEO and Chief Investment Officer, he has ultimate responsibility for the firm's investment team, strategies and overall management of the firm. Mr. Senser is a member of the firm's executive management committee. He graduated with a B.A. from the University of Michigan and an MBA from the University of Chicago. Before joining Institutional Capital, Mr. Senser spent seven years at Stein Roe & Farnham as an Associate involved in economic and fixed income analysis. He began his career at Data Resources Inc., an economic consulting firm. He has been featured in publications such as *Barron's*, *The New York Times* and *Value Investor Insight*, and has been a guest speaker on CNBC and "Consuelo Mack WealthTrack." Mr. Senser has been with the firm since 1986 and in the industry since 1978.

SECTOR — GENERAL INVESTING

TWST: You use a bottom-up approach to select stocks from the large-cap segment of the market. Have you noticed any trends as far as certain sectors being more likely recently to include the kinds of stocks Institutional Capital is looking for?

Mr. Senser: There have been wide performance divergences between various sectors of the market. The behavior in the second quarter was very similar to what we saw in the third quarter of last year and in 2008. There was deterioration in expectations about global economic growth and increased concern about financial conditions, particularly in Europe. As a result, investors looked for safety and security and moved toward more defensive sectors like utilities, staples and telecommunications. I think that has led to some pretty wide valuation disparities between different sectors.

TWST: Please tell us about how you find pricing efficiencies within the large-cap segment.

Mr. Senser: We believe that there are pricing inefficiencies in the large-cap sector of the market. Our investment process focuses on valuation and catalyst identification in order to exploit those perceived inefficiencies on a consistent basis. We also take a global perspective, which we feel is important in the large-cap area. Most of the companies we follow are multinational in nature, so it's important to have a perspective on their competitors outside the U.S.

Our equity selection process has not changed over time and involves three different stages. First, we try to identify best values. Our analysts divide the world into 14 different economic sectors and develop target prices for the approximately 1,100 stocks in our investment universe. Those targets reflect normalized earnings, or earnings that we would expect the company to be able to achieve over the course of an economic cycle. At this stage, we also try and eliminate value traps. Value managers often get into trouble by buying stocks that appear cheap, only to see the company's fundamental earnings power erode. To address this problem, we eliminate stocks where consensus earnings estimates are in decline. Overall, we look for stocks that we believe have at least 15% upside to their target price and have stable-to-rising consensus earnings estimates. This subset usually comprises about 20% of our investment universe, and in our view provides a very attractive group of stocks for further review.

The second stage of the process is catalyst identification. Here, we look for specific conditions or factors that potentially will change the market's perception about a stock and move it closer to its warranted target price. Stock-specific catalysts include management, restructurings, new products, problem-fixing situations and pricing flexibility.

In addition to stock-specific catalysts, there can be thematic catalysts that operate in the portfolio. Thematic catalysts are based on macroeconomic or general industry conditions. We believe the focus on catalysts provides several advantages to the portfolio. First, it's an important risk-control mechanism. If a catalyst erodes or is broken, we don't try and reconceptualize an investment idea. We generally sell the stock from the portfolio. Secondly, catalysts help highlight areas of inefficiency in the market that we can return to time and time again to find stocks that we believe have good potential.

The third and final stage in the investment process is portfolio construction. In this stage, the analysts present their ideas to the portfolio management team. The team evaluates the ideas and selects the most compelling stocks for the portfolio.

TWST: One of the firm's strategies is to avoid so-called value traps. Would you give us an example of a company that fell into that category, that looked attractive initially but has appeared to be a value trap upon further inspection?

Mr. Senser: Staples (SPLS) would be one example where the stock appeared inexpensive but where fundamental conditions ultimately proved to be unfavorable. **Staples** is in an industry that has potential for consolidation, which we believe would be beneficial for the company. A better economic environment also would help boost office product sales, which is their primary business. However, what we have seen instead is that the combination of soft economic conditions and problems that developed in their European operations has led to ongoing business shortfalls. As a result, the catalyst that we anticipated didn't materialize, and we sold the stock in July of last year.

Highlights

Jerrold K. Senser of Institutional Capital LLC discusses the firm's investment strategy, including the ways to avoid so-called value traps. He says the firm's investment process focuses on valuation and catalyst identification to exploit perceived inefficiencies on a consistent basis. Mr. Senser also says he takes a global perspective, which he believes is important in the large-cap area. He gives examples of holdings and their respective catalysts. Mr. Senser shares insights on the types of clients he believes would be an ideal match for the firm and its investment strategy.
Companies include: Staples (SPLS); Viacom (VIA); BB&T Corporation (BBT) and Texas Instruments (TXN).

TWST: Would you give us three examples of holdings you believe are particularly representative of Institutional Capital's strategy? You talked about catalysts being a big part of the strategy. For each of the three holdings you mention, would you tell us what was the catalyst that directed you to that stock?

Mr. Senser: Viacom (VIA) would be a good example of the overall process and approach. **Viacom** has two stock-specific catalysts — pricing flexibility and problem fixing. The company is driven primarily by its cable networks business. They have brands like MTV, Nickelodeon and Comedy Central. **Viacom**'s networks generate over 90% of the company's operating income. We believe that content is increasingly important in the digital world. There are many distribution outlets that need content in order to compete, and this helps give **Viacom** significant pricing flexibility. Such flexibility is very difficult to find in the current economy. The company just reported second-quarter earnings and indicated that affiliate revenues, which are the fees they receive from the distributors for their content, are expected to grow in high single digits to low double digits over the next several years. That kind of pricing flexibility for affiliate fees is very important to drive the revenue and cash flow that **Viacom** receives.

In terms of the problem-fixing catalyst, **Viacom** has had rating issues at Nickelodeon over the past year. We believe management's efforts to improve the programming and introduce new shows ultimately will bear fruit and help stabilize the ratings for Nickelodeon. That would clearly help improve the perception of the company.

In addition to its pricing flexibility and problem-fixing catalysts, **Viacom** also is expected to benefit from a thematic catalyst we call "earn and return cash." **Viacom** currently generates significant amounts of free cash that it is returning to shareholders. Management has planned to buy back close to $3 billion in the company's stock both this year and next. That is significant given that the market capitalization of the company is around $26 billion.

Between dividends and share repurchases, investors are projected to receive over 10% of the market capitalization of the company in both 2012 and 2013. We believe companies which have significant, sustainable cash-generating abilities and which return a large portion of that cash to shareholders through dividends or share repurchases should be attractive to investors in an environment of low interest rates. **Viacom** is representative of that thematic catalyst.

TWST: Would you share another example?

Mr. Senser: BB&T Corporation (BBT), which is a North Carolina-based bank. The stock-specific catalyst that we find compelling for **BB&T** is management. We believe management has done an excellent job positioning the company to take advantage of the current environment and grow the company's market share and earnings. Their conservative posture in terms of the bank's lending practices and the prudent handling of their balance sheet put them in a position to be a market share and profit leader coming out of the global financial crisis.

"Viacom would be a good example of the overall process and approach. Viacom has two stock-specific catalysts — pricing flexibility and problem fixing."

They have been able to use their financial strength to make acquisitions, which has helped advance their competitive position. In August of 2009, they bought Colonial Banking, which significantly improved their market share in Florida. Last July, they closed on the acquisition of BankAtlantic, which more than doubled their financial presence in the greater Miami area.

Finally, **BB&T** bought the Crump Group last April, which enhanced their insurance brokerage revenue by 25%.

In addition to the stock-specific management catalyst, **BB&T** is a good example of another thematic catalyst that we have operating in the portfolio that we call "the strong will get stronger." In an environment where global growth is pretty subdued, companies with strong balance sheets should be able to use their financial strength to prey on their weaker competitors and enhance their revenues and earnings. **BB&T** is an excellent example of that catalyst.

1-Year Daily Chart of Viacom

Chart provided by www.BigCharts.com

TWST: Is there a final one you would like to mention?

Mr. Senser: Yes, I would highlight **Texas Instruments** (TXN). The stock-specific catalysts are management and new products. We have a very high regard for the management at this company. **Texas Instruments** has gone through an important transition. Management has moved their business away from wireless semiconductors, which have become more commoditized, toward higher-performing, higher-margin analog semiconductors. They did this over the past couple of years, and it was executed extremely well, in our opinion.

Management also has been very astute and purchased semiconductor capacity during the downturn at very low prices. They made a number of acquisitions during 2009 and 2010, both for semiconductor capital equipment and for fabs. We think these actions position the company extremely well and should allow management to show significant improvement in margins as they fill out low-cost capacity.

On the new product front, they recently purchased National Semiconductor. This acquisition expands **Texas Instruments**' analog product portfolio by 40%. In addition to a high-quality portfolio of products, National Semi brings solid gross margins and quality design engineers. **TI** saw a company that had damaged its relationships with customers through very poor pricing behavior, which prevented many National chips from being designed into products. We think that **Texas Instruments** is going be a breath of fresh air there. Overall, we see the potential for significant operating margin and profit improvement.

Finally, in our view, management is doing an excellent job managing capital. They have used their free cash to lower their share count significantly. In fact, the share count has declined by 25% between 2006 and 2011. Management targets the return of all free cash flow to shareholders through dividends and share repurchases.

TWST: What is the most challenging aspect of your job as CEO and Chief Investment Officer of an investment firm using a large-cap value strategy?

Mr. Senser: Well, many people view the large-cap market as very efficient. However, as I indicated before, we think there is considerable opportunity in the large-cap market for active managers, assuming you have a strong investment process, a strong investment team and an intense focus on your work. In fact, with wide disparities evident in valuations between different sectors of the large-cap market, we believe it could be a particularly rewarding time for active management.

TWST: What do you see as the most significant risks for investors right now? And how does Institutional Capital's strategy seek to mitigate the negative impact of those risks for clients?

Mr. Senser: We are in an environment where there are a number of potential outcomes given economic conditions, given political conditions and given conditions in Europe. These uncertainties face investors whether they are investing in bonds, stocks or other asset classes. We have tried to tailor our approach for the current environment and look for stocks that fit our themes of "the strong will get stronger" and "earn and return cash." In addition, the large-cap nature of these companies can provide investors with some degree of comfort given their financial strength and their diversified business and geographic model.

TWST: How would you describe the investor who you believe is going to be an ideal match for Institutional Capital?

Mr. Senser: Clients look for a strong investment process, a strong group of people and a strong culture. I believe our clients also recognize that the investment business is a marathon, not a sprint. We are in the business of trying to generate good returns over a market cycle. To the extent that people are looking for those qualities, then I think we have the closest match in terms of what we can deliver for investors.

TWST: Thank you. (MES)

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